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NEW HOME MORTGAGE DISCLOSURE ACT PRICING DATA: THE NEXT ENFORCEMENT AND LITIGATION FRONT FOR LENDERS

Now Required to Publicly Report Pricing Information on Home Mortgage Loans, Lenders Can Expect Class-action Litigation Asserting Disparate-impact Discrimination Claims. The Authors Review Some Defenses to Such Claims, the Effect of the Federal Class Action Fairness Act, and the Impact of Amendments to Federal Rule 23.

By Benjamin B. Klubes and Benjamin P. Saul*

The Home Mortgage Disclosure Act's ("HMDA")[1] new requirement that lenders publicly report pricing information for home mortgage loans likely will spur significant regulatory examinations, law enforcement investigations and class action litigation regarding alleged race-based lending discrimination. Media focus on the newly available data already has resulted in negative press stories about lenders whose data, based on preliminary, superficial analyses, shows a greater proportion of minorities with higher cost loans than whites. Although banking regulatory agencies agree that the new HMDA data, which does not include creditworthiness and other information lenders utilize for risk-based pricing, cannot conclusively support discrimination determinations, they believe the data will help to identify what lenders, products and geographies they should examine and investigate further. Inevitably, such examinations and investigations will result in additional federal and state law enforcement activity. Class actions also will be filed. Those class actions will utilize the newly reported data to advance claims under existing anti-discrimination laws, including the Equal Credit Opportunity Act ("ECOA")[2] and the Fair Housing Act ("FHA"),[3] premised on already common disparate impact theories.

1. 12 U.S.C. §§ 2801-2810.
2. 15 U.S.C. §§ 1691-1691f.
3. 42 U.S.C. §§ 3601-3631.

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This article describes the new HMDA requirements in Section II below. Section III discusses expectations regarding analysis of the new data. Section IV outlines likely regulatory, law enforcement and class action activity that will arise from the new data, focusing in particular on class action issues relating to the legal theories that can be advanced and the implications of the recently enacted Class Action Fairness Act and changes to Rule of Civil Procedure 23 regarding class action settlements. Finally, Section V discusses proactive steps lenders can take to minimize risk in this area.

THE NEW PRICING DATA REQUIREMENTS

Originally enacted in 1975, the HMDA requires depositary institutions, including banks, savings associations and credit unions, to collect and disseminate data on mortgage loans and applications for such loans. The purpose of the HMDA, through its implementing Regulation C,[4] is to provide information on whether financial institutions serve the housing credit needs of the neighborhoods and communities in which they are located. Until this year, Regulation C required that, for each application for a real estate-secured loan, financial institutions collect data on an applicant or borrower's race, national origin and sex as well as the following information: (1) the date the application was received; (2) the type and purpose of the loan; (3) the owner-occupancy status of the property; (4) the amount of the loan application; (5) the type of action taken and the date; (6) the location of the property to which the loan relates by Metropolitan Statistical Area ("MSA"), state, county and census tract (if the institution has a home or branch office in that MSA); (7) the income relied upon in processing the loan application; and (8) the type of entity purchasing the loan the institution originates or purchases and then sells within the same calendar year.[5]

In 2002, the Federal Reserve Board promulgated a final rule that amended Regulation C.[6] These amendments took effect on January 1, 2004, and require depositary institutions[7] for the first time to (1) report the *rate spread*

4. 12 C.F.R. §§ 203.1-203.6.

5. 12 C.F.R. § 203.4.
6. Home Mortgage Disclosure, 63 Fed. Reg. 12,329 (Mar. 12, 1998); Home Mortgage Disclosure, 67 Fed. Reg. 7222 (Feb. 15, 2002) (codified at 12 C.F.R. pt. 203).
7. Regulation C requires a depository institution to report under HMDA in 2005 if the institution's total assets are $33 million or more; it does business in a metropolitan area; the institution originated at least one home purchase loan or refinancing; and either (1) the institution is federally insured or regulated, (2) the mortgage loan was insured, guaranteed or supplemented by a

(footnote continued on next column...)

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or differential between a loan's annual percentage rate and the yield on comparable Treasury securities for first-lien loans when the rate spread is at least 3 percentage points and for subordinate-lien loans when the rate spread is at least 5 percentage points; (2) identify loans subject to the Home Ownership and Equity Protection Act ("HOEPA"); (3) report whether a loan or application involves a manufactured home; (4) report denials of requests for preapprovals; (5) characterize loans using the definitions of a "refinancing" and "home improvement loan" as revised by the rule; (6) obtain information on the applicant's race, ethnicity, and sex for all applications completed in person, by mail, on the phone or over the internet.[8]

Lenders were required to report their 2004 HMDA data on March 1, 2005. Lenders must respond to all public requests for their 2004 HMDA data made after March 1, 2005 within 30 days. Throughout this year, the Federal Financial Institutions Examination Council will compile and distribute publicly available HMDA data reports, including disclosure statements on each lender's activities in metropolitan areas. In August or September of 2005, the Federal Reserve Board will release the 2004 HMDA on CD-Rom.

DATA EXPECTATIONS AND ANALYSIS

Release of the new HMDA pricing data is awaited eagerly by community groups, the media and class action lawyers. Many have already requested HMDA data from financial institutions individually. They are not waiting for the government to publish the data in the Fall of 2005 before analyzing it themselves — and likely will act on those analyses. The bank regulatory agencies also are analyzing the data and plan to review the new HMDA pricing data as part of the fair lending examination process. In fact, as early as mid-2004, the Office of the Comptroller of the Currency had requested partial year pricing data from lenders for purposes of conducting its analysis.[9] The Federal Reserve has done the same.

Community groups committed to policing anti-discrimination laws seem convinced that the new HMDA pricing data will provide a wealth of information and a basis to attack discriminatory pricing practices and even "predatory" lending. Preliminary analyses of data lenders have shared with community groups has resulted in adverse publicity for lenders. For example, the Wall Street Journal reported on March 30 that it obtained and shared with the National Community Reinvestment Coalition the new HMDA pricing data from one major national lender and found that minorities were twice as likely as white borrowers to have loans that reached the new HMDA data price trigger levels.[10]

Bank regulators and law enforcement officials have recognized, however, that the data are missing fundamental creditworthiness information (e.g. FICO scores), and other objective pricing criteria critical to analyzing the pricing practices of financial institutions. Specifically, on March 31, the banking regulatory agencies (Federal Reserve, OCC, OTS, FDIC and NCUA) as well as the Department of Housing and Urban Development issued a Joint Statement entitled "Answers to Frequently Asked Questions About New HMDA Data." The Joint Statement explained:

> The data, for example, do not include certain determinants of credit risk that may explain higher loan prices, such as the borrower's credit history, loan-to-property-value ratio, and consumer debt-to-income ratio. **Consequently, the HMDA data are not, by themselves, a basis for definitive conclusions regarding whether a lender discriminates unlawfully against particular borrowers or takes unfair advantage of them.** (emphasis added).[11]

(footnote continued...)

federal agency, or (3) the mortgage loan was intended for sale to Federal National Mortgage Association (Fannie Mae) or Federal Home Loan Mortgage Corporation (Freddie Mac). Under Regulation C, non-depository for-profit lenders also must report if they have an office or have originated more than 5 loans in a MSA, have assets that exceed $10 million or have originated at least one hundred home purchase or refinance loans, and such mortgage lending must have constituted 10 percent or more of their loan volume. The 10 percent limitation is waived for non-depositories with assets in excess of $25 million.

8. Id.

9. "OCC Asks Banks to Monitor Prices," National Mortgage News, Vol. 29, No.6 (Oct. 18, 2004).
10. The Wall Street Journal, at D2 (Mar. 30, 2005).
11. Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, "Answers to Frequently Asked Questions About New HMDA Data" (March 31, 2005).

Despite the acknowledged data limitations, bank regulators have urged financial institutions to undertake their own analyses of the new HMDA pricing data as a compliance measure and to prepare to address any concerns that may arise from the public disclosure of the data. Law enforcement and bank regulators however, already are spending substantial resources to analyze the data because they believe it will help them understand financial institutions' pricing practices and will point them toward potential discrimination issues. As the Joint Statement indicated: "Government agencies use HMDA data to identify institutions, loan products or geographic markets that show disparities in the disposition of loan applications by race, ethnicity, and other characteristics that require investigation under ECOA or FHA. With the addition of the price data for higher-priced loans, the agencies will also be able to identify more easily price disparities that require investigation."[12]

The lending industry is well aware of the intense scrutiny that various government agencies and groups will give to the new HMDA pricing data. Trade associations and individual lenders have undertaken analyses of the new HMDA pricing data. Such analyses must be comprehensive and careful to address the possibility that flawed studies using incomplete data will complicate, rather than simplify, public understanding of the HMDA pricing data.

REGULATORY, LAW ENFORCEMENT AND CLASS ACTION ACTIVITY

Bank Regulators

As the bank regulatory agencies expressed in their Joint Statement, they will utilize the new HMDA pricing data to identify areas of interest for examination. Clearly, there will be an even greater examination focus on pricing fairness. Further, bank regulators will have heightened expectations regarding lenders' obligations to analyze their own HMDA pricing data and address any issues related to pricing disparities among protected classes.

Federal and State Law Enforcement

The Department of Justice Civil Rights Division has responsibility for enforcing ECOA and FHA. State Attorneys General typically have responsibility for enforcing analogous state anti-discrimination laws. Both federal and state law enforcement agencies recognize that the new HMDA pricing data will provide a wealth of information to initiate investigations of potential discriminatory pricing. They are devoting resources to having the capability to analyze and utilize that data. Moreover, the heightened public attention to fair lending issues generated by the release of the new HMDA pricing data will spur federal and state enforcement activity.

Class Action Litigation

Class action lawyers also will scrutinize and likely use the new HMDA pricing data in lawsuits alleging lending discrimination under FHA and ECOA — particularly to advance disparate impact theories. At the same time, major changes to federal class action law will reshape how both plaintiffs and defendants approach class lawsuits.

1. New Litigation Using Old Theories

Plaintiffs have long employed statistical methodologies that rely principally upon HMDA data that plaintiffs supplement with qualitative data, including loan files, to establish prima facie cases of lending discrimination. The HMDA price data disclosure requirements will enable plaintiffs to strengthen class wide claims of discrimination related to lender pricing of loans to protected classes of persons. Notwithstanding the fact that the HMDA data does not include lenders' creditworthiness criteria and, therefore, fails to reflect lenders' actual pricing practices, plaintiffs likely will utilize it to try to prove, through disparate impact and disparate treatment theories, lending discrimination under FHA and ECOA. These statutes, the discrimination claims under them that plaintiffs likely will seek to establish using the new HMDA data and lenders' main defenses to those claims are summarized below.

ECOA, as implemented by Federal Reserve Board Regulation B, prohibits financial institutions from discriminating in the provision of credit on the basis of race, color, religion, national origin, sex, marital status, age or because the applicant has, in good faith, exercised any right under ECOA, or because all or part of an applicant's income derives from a public assistance program.[13] Some courts have held that ECOA prohibits practices with discriminatory impacts in addition to

12. Id. at 2 (question 6).

13. 15 U.S.C. § 1691(a)(1)-(3).

those with discriminatory intents, but this case law is subject to challenge.[14]

FHA renders it unlawful for persons "whose business includes engaging in residential real-estate related transactions" to discriminate against "any person" in those transactions on the basis of race, color, religion, sex, financial status, or national origin.[15] Other provisions of FHA make it unlawful to "make unavailable or deny" a dwelling, or to discriminate "in the provision of services or facilities" in connection with the sale or rental of a dwelling, because of race, color, religion, sex, familial status or national origin.[16] Historically, though some courts have held or suggested that private defendants are not subject to a discriminatory effects test under FHA without evidence of some discriminatory intent, other courts have permitted plaintiffs to allege discrimination against them under a disparate impact theory.[17]

Under ECOA and FHA, plaintiffs must first establish a prima facie case of lending discrimination. To do so under the disparate impact theory, plaintiffs must prove that a particular practice adversely effects a protected class. Generally, plaintiffs attempt to meet their burden through statistical evidence that allegedly shows a particular practice disproportionately affects a protected group. In claims of pricing discrimination, plaintiffs now are able to utilize HMDA pricing data to satisfy this initial burden.

Lenders forced to defend disparate impact claims under either FHA or ECOA have asserted three basic defenses. First, lenders have argued that no cause of action exists for disparate treatment or disparate impact theories under either Act. Second, they have asserted that plaintiffs have failed to establish a *prima facie* disparate impact case because the statistical methodology purporting to demonstrate the discriminatory effects is fatally flawed. Third, when plaintiffs carry their initial burden, lenders generally have set forth a non-discriminatory business justification for the challenged practice. Risk-based pricing provides a strong business justification for disparate impact on protected classes of persons notably, in the context of discriminatory pricing lawsuits.

Courts have not looked favorably on lenders' claims that a cause of action for disparate impact does not exist under FHA or ECOA, assuming, often with only cursory analysis, that plaintiffs possess such causes of action. Recent United States Supreme Court jurisprudence, however, has created a ripe opportunity for lenders to renew old challenges to this general assumption. In 2001, the Supreme Court, in *Alexander v. Sandoval*,[18] held that only Congress, through constitutionally enacted statutes, may create causes of action. During the current term, the Supreme Court again opined on the availability of disparate impact theory in *Smith v. Jackson*, rejecting the view that "disparate-impact theory of liability is categorically unavailable under the ADEA," but narrowly circumscribing its availability. Read together, these decisions suggest the Court is reluctant to imply private rights of action under disparate impact theory — a reluctance on which lenders should try to capitalize by arguing that, post-*Sandoval* and *Smith*, a more stringent textual analysis to claims brought under ECOA and FHA demonstrates that the text of neither statute explicitly prohibits neutral-intent policies that have a discriminatory effect. Thus, disparate impact theory is not cognizable under either ECOA or FHA.

Class Action Fairness Act

On February 18, 2005, President Bush signed into law the Class Action Fairness Act of 2005 ("CAFA"),[19] which overhauls the current class action litigation system. The CAFA greatly expands federal courts ability to exercise jurisdiction over class action lawsuits and increases judicial scrutiny of settlements and plaintiffs' counsel's fees for cases commenced after its February 18, 2005 effective date. As a result, lenders will have a greater opportunity to have federal courts, rather than state courts, adjudicate the anticipated wave of HMDA-related

14. See, e.g., Powell v. American General Fin., Inc., 310 F.Supp. 2d 481, 487 (N.D.N.Y. 2004);Osborne v. Bank of America, Nat. Ass'n, 234 F.Supp. d 804, 811-12 (M.D. Tenn. 2002).
15. 42 U.S.C. §§ 3605(a); 24 C.F.R. §§ 180.671 & 180.705.
16. 42 U.S.C. §§ 3604(a) & (b); 24 C.F.R. § 100.60.
17. For example, compare Brown v. Artery Org., Inc., 654 F.Supp. 1106 (D.D.C. 1987) (rejecting disparate impact claim under FHA that tenants brought against private defendants who converted a low-rent apartment complex into high-rent units), with Betsey v. Turtle Creek Assocs., 736 F.2d 983, 987 (4th Cir. 1984) (recognizing "parallel objectives of Title VII and [FHA]" when applying disparate impact analysis in case against private defendant) and Pfaff v. HUD, 88 F.3d 739 (9th Cir. 1996) (intent to discriminate not required to establish prima facie case of disparate impact under FHA even when defendant is private landlord).
18. 532 U.S. 293.
19. Pub. L. No. 109-2, 119 Stat. 14.

class action litigation.

Lenders have long recognized the substantial uncertainty and risk associated with defending nationwide class action lawsuits, particularly when they are in state courts that plaintiffs' have chosen due to plaintiff-oriented judges and law in certain specific jurisdictions. The CAFA offers significant new procedural protections to lenders that plaintiffs have targeted in nationwide class action litigation and in mass litigations consolidated in state court.

Under prior law, a class action was relegated to state court unless each class member sought damages of at least $75,000 (occasionally courts modified this rule to extend only to named plaintiffs) and all named plaintiffs were citizens of different states from all named defendants. The CAFA amends the diversity jurisdiction statute (28 U.S.C. § 1332) to give federal courts original jurisdiction in class actions that involve at least $5,000,000 in controversy, exclusive of interest and costs, and in which any member of a class of plaintiffs is a citizen of a different state from any defendant.

The CAFA also enhances a single defendant's capability to remove a class action to federal court. Under prior law, a defendant could remove a case from state court to federal court only if all other defendants consented, and a defendant that was a citizen of the state in which the state court action was filed had no removal rights. The CAFA now permits any defendant that otherwise meets its diversity requirements to remove an interstate class action to federal court "without the consent of all defendants" and "without regard to whether any defendant is a citizen of the state in which the action is brought."[20] The CAFA's expansion of defendants' ability to remove state actions to federal court provides lenders with a powerful tool to address so called "mass actions," in which unrelated plaintiffs are joined into one action not designated as a class. Under the CAFA, lenders may remove such mass actions to federal court to the same extent as a properly designated class action lawsuit.

The CAFA also creates federal appellate review of orders granting or denying remand of removed cases. Before the CAFA, defendants had no right to appellate review of orders that remanded a case to state court, and, therefore, were forced to litigate in state court even when the remand order was in plain error. The CAFA, however, permits federal appellate courts to accept an appeal of an order remanding a case and provides defendants with immediate review of an erroneous remand order. Such new appellate rights could potentially save a defendant years of costly and needless litigation before state courts.[21]

Upon satisfying the CAFA's removal criteria, lenders now may remove individual HMDA-related class actions and mass actions filed in a state court to federal court. Likewise, lenders faced with multiple state law discrimination claims now may utilize the CAFA provisions to remove and consolidate such claims into a class action in federal court. Lenders, moreover, now have appellate rights for erroneous remand decisions. To position themselves to litigate and resolve matters in federal court, lenders should take discovery regarding the citizenship of all putative class members to determine if they can utilize the CAFA's jurisdictional provisions.

Amendments to Rule 23

On December 1, 2003, extensive amendments to Rule 23 of the Federal Rules of Civil Procedure took effect. Although these revisions impact many important areas of class action practice, the most significant changes to existing practice, and the changes most likely to impact HMDA pricing litigation, concern Rule 23(e) and the class settlement process. The revisions to Rule 23(e) increase judicial oversight of class action settlements,

20. There are limits to defendants removal rights under the CAFA. The "local controversy exception" leaves in state court cases in which over two-thirds of the class members are citizens of the state and either the "primary defendants" are citizens of the state or at least one of the defendants from who "significant relief" is sought is a state citizen and the conduct and harm occurred in the state. Further, in the interests of justice and based on the totality of the circumstances,, federal courts may decline to exercise their jurisdiction when greater than one-third, but less than two-thirds, of putative class members and the primary defendants are citizens of the state in which the action was first filed.

21. The CAFA also limits attorney fees in "coupon settlements," in which plaintiffs get discounts on products instead of financial settlements. Under the CAFA, such attorney fees will be based on the value of the coupons that are redeemed or the amount of time class counsel spent working on the action. Before a court may approve a coupon settlement, it now must conduct a hearing and render findings on the settlement's fairness to class members.

which should result in heightened scrutiny by courts of both class settlements and any ancillary agreements.

Rule 23(e)(3) has been altered to permit courts to condition their approval of class settlements for classes certified under Rule 23(b)(3) in which the original opt-out period has lapsed on a re-notice to the remaining class members that provides them with a second opportunity to opt-out of the class. Previously, under Rule 23(e)(3), a class member in a contested but certified class who failed to opt-out by the deadline had to remain in the class even if a later settlement was reached that the class member deemed undesirable. Although such class members retained objection rights, Rule 23(e)(3) was altered to enable individual class members to better compare the value of their individual claim to the class claims.

The new Rule 23(e)(3)'s effect is limited. Only individual class members may opt-out, and no class member may purport to opt-out other class members by way of another class action.[22] This change, moreover, does not impact cases in which the parties do not contest, and a court grants, certification in connection with a proposed negotiated settlement.

Notwithstanding its limited scope, the "second opt-out" amendment will add an element of uncertainty to settlement agreements entered into after a contested class has been certified. Parties in such class lawsuits must anticipate the risk of second chance opt-outs and should draft settlement agreements in a way that cabins that risk consistent with the circumstances of the litigation. In the event that a court requires re-notice and second chance opt-outs, parties should seek appropriate limits on such opt-out rights. For example, it might make sense for a court to bind class members who exercise a second chance opt-out right to its prior merits rulings. Such initial guidance from the court will reduce the risk that class members will misuse second chance opt-out rights.

The new Rule 23(e)(2) further complicates the class settlement process. The rule requires all parties who seek court approval of a class action settlement to "file a statement identifying any agreement made in connection with the proposed settlement." Neither the Rule, nor the Advisory Committee's comments on it, state whether such "side agreements" must be material or in writing. The Advisory Committee has stated the new rule requires parties to disclose "related undertakings that, although seemingly separate, may have influenced the terms of the settlement by trading away possible advantages for the class in return for advantages for others," and cautions that "[d]oubts should be resolved in favor of identification."[23]

Despite its broad scope, Rule 23(e)(2)'s disclosure requirement has some limits. Although the rule contemplates that all terms of certain side-agreements, ultimately, may need to be disclosed, the rule requires parties, initially, only to identify the agreements. The Advisory Committee has recognized that disclosure of certain types of agreements "may raise concerns of confidentiality," that some agreements will include "information that merits protection against general disclosure" and that courts, therefore, may need to provide parties with an opportunity to claim work-product or other protections.[24] The Advisory Committee also has cautioned that "[f]urther inquiry into the agreements identified by the parties should not become the occasion for discovery by the parties or objectors" and has indicated that courts have discretion to "act in steps, calling first for a summary of any agreement . . . and then for a complete version" if the summary fails to provide an adequate basis for review.[25]

The new Rule 23(e)(2) may greatly impact how parties settle class actions. Given the Rule's broad language that requires parties to identify any agreements "in connection" with class settlements, parties will need to carefully consider whether to enter into, or even negotiate, side agreements. Although the Advisory Committee has cautioned courts that the disclosure of side agreements should not trigger additional discovery, until consistent practice develops to the contrary, parties must operate as though such discovery is likely. When a matter requires ancillary agreements, parties must consider how the court, the parties and possible objectors might react to, and must properly time when they negotiate and close, such agreements. In cases in which ancillary settlements with potential objectors are necessary, careful planning before engaging such objectors will avoid a chain reaction that could place the overall class settlement in jeopardy.

22. Fed. R. Civ. P. 23, Advisory Committee Notes, 2003 Amendments.

23. Id.
24. Id.
25. Id.

The remaining amendments to Rule 23(e) either clarify ambiguities or confirm federal practice grounded on interpretations of the old rule. Rule 23(e)(1)(A) now is explicit that court approval is required only for the settlement, dismissal or compromise of claims, issues or defenses of a certified class. For settlements requiring court approval, Rule 23(e)(1)(B) now requires that courts direct notice to all class members who would be bound by such agreements. The amended Rule 23(e) also codifies the well-accepted federal practice of holding a hearing to determine the fairness of a proposed settlement. Finally, Rule 23(e)(4) confirms that class members may object to proposed settlements, voluntary dismissals or compromises that require court approval, but now adds that objectors may withdraw objections only with court approval. Although the revisions to Rule 23(e)(4) will diminish objectors' ability to extract settlement sums greater than the amounts designated for class members, it likely will also require defendants to address more of the objections directly.

PROACTIVE PREPARATION FOR LENDERS

Given the likelihood of public scrutiny, examination, investigation and litigation, lenders need to consider taking proactive steps to minimize their risks. The most important aspect of being able to address issues with respect to the HMDA data is to have an understanding of the facts. This means conducting analyses of HMDA data under appropriate attorney-client privilege and work-product protections. To the extent that such analyses reveal pricing issues, lenders must undertake efforts to understand and address their root causes.

Lenders also should develop a credible explanation of their HMDA pricing data that they can share with the public. This effort can be complicated because lenders do not publicly report important data necessary to explain pricing decisions. Nonetheless, lenders must recognize and embrace how important it is to communicate effectively with different audiences about their pricing.

In sum, the best proactive risk mitigation measures involve understanding and analyzing the facts of an institution's lending pricing, and addressing any identifiable issues regarding pricing disparities promptly and positively. ■